

# China's Personal Income Tax Reform in 2018 from the Perspective of Fairness

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**Abstract:** On August 31, 2018, the fifth session of the standing committee of the 13th national people's congress passed the decision on amending the individual income tax law and put forward a number of reform measures. In this tax reform, on the basis of increasing the amount of exemption and adjusting the gap between tax rates, the four incomes of wages and salaries, remuneration for labor services, remuneration for contributions and royalties are included in the annual comprehensive income. This article builds a comprehensive and classified personal income tax system, and adds six additional special deductions to achieve a substantial breakthrough in personal tax reform. This article analyzes the practical significance and existing problems of this tax reform from the perspective of fairness, and proposes measures to solve the existing problems.

## 1. Introduction

The importance of income is becoming more prominent. According to data from the National Bureau of Statistics, the individual tax revenue in 2017 was 1,193.337 billion yuan, accounting for 8.29% of the total tax revenue for that year. Individual tax revenue in 2018 was 1,387.197 billion yuan, accounting for 8.87% of total tax revenue for the year. Personal income tax has become the third largest tax after VAT and corporate income tax. Both VAT and corporate income tax are based on enterprises, while the main taxpayers of personal income tax are individual residents, which are closely related to residents' income. At present, the social contradictions in our country have been transformed into the contradictions between the increasing material and cultural contradictions of the people and the unbalanced and inadequate development. The individual income tax must comply with the requirements of the times and give full play to the function of income regulation. Individual income tax should embody the principle of "fairness" in income regulation. The horizontal fairness of individual income tax means that people with the same economic capacity should pay the same tax. The vertical fairness of individual income tax means that people with different economic capacity should pay different taxes. Through "capacity tax", we can levy heavy tax on the high-income people, moderate tax on the middle-income people, and less tax or even no tax on the low-income people, so as to reduce the gap between the rich and the poor, ease the social contradictions of all levels, and promote the harmonious and stable development of society.

From 1980 to 2017, personal income tax has undergone six reforms. Previous reforms focused on the adjustment of exemption and tax rate. The personal tax reform in 2018 is the most vigorous and extensive. On the basis of increasing the amount of exemption and adjusting the level distance of tax rate, the classified tax system is adjusted into a tax system combining comprehensive and classification, and the concept of additional deduction is put forward for the first time, creating a new era for the deepening reform of personal income tax.

## 2. Background of Personal Income Tax Reform

### 2.1 Classified Tax System, Item by Item, Regardless of Person

Previously, China's personal income tax adopts the classified tax system, which divides personal income into 11 categories such as wage and salary income and labor remuneration according to the source, and is taxed at the corresponding tax rate. The biggest drawback of the classified tax system is that "items are not divided into different persons". The tax is levied at the applicable tax rate by

deducting the deduction items according to the income source category, and the income is not integrated according to the taxpayer, resulting in different tax burden of the same taxpayer due to different income sources.

For example, under the exemption of the original wage and salary of 3500 yuan and the service remuneration of 800 yuan, taxpayer A obtains the wage income of 4000 yuan, which needs to be taxed. Taxpayer B obtained 3300 yuan of wage income and 700 yuan of labor remuneration, both of which did not reach the amount of exemption, and neither of which was subject to tax. The total income of taxpayers A and B in the current month is the same, result A needs to pay tax, and B does not pay tax. Before the tax reform, the working class with the simplest income has become the group that is least likely to evade taxes. On the other hand, taxpayers with a wide range of income sources and a complicated structure will not easily reach the exemption amount and become a vacuum zone for tax collection. This is not in line with the principle of horizontal equity of personal income tax.

## **2.2 Monthly Tax before the Tax Reform**

Under the original tax system, individual taxes were levied on a monthly basis. Under the original tax system, taxpayer A received a salary of 3,000 yuan in January and 4,000 yuan in February. He will not pay tax in January and pay tax in February. If you get 3,500 yuan per month, the exemption has just arrived and no tax is required. It can be seen that under the original tax system, the total income of the whole year is the same, but the tax burden borne by the taxpayers whose income fluctuates greatly in each month will be higher than that of the taxpayers whose income is average, which is not in line with the horizontal equity principle of personal income tax. Under the new tax system, the comprehensive income is calculated on an annual basis, and the accumulated withholding method is used to calculate the tax, so as to avoid the unfair tax burden caused by the fluctuation of monthly income.

## **2.3 Tax on Income Only, No Additional Charges Taken into Account**

In the original tax system, personal income was taxed directly, and other expenses such as family support, education and medical care were not taken into account. Taxpayers with the same nominal income have different tax bearing capacity due to different family composition and living expenses. Paying taxes only on personal income is not in line with the principle of vertical equity of personal income tax, that is, taxpayers with different economic affordability should pay different taxes.

## **3. Basic Content and Practical Significance of This Tax Reform**

(1) From October 1, 2018, the personal income tax exemption was adjusted from 3,500 yuan / month to 5,000 yuan / month, and the scale of the low-grade tax rate was increased, and the scale of the high-tax rate remained unchanged.

From the comparison of the new and old tax rates in Table 1, it can be seen that the tax rate after tax reform is still the original 7-level progressive tax rate, but the tax rates of 3%, 10% and 20% of comprehensive income have been expanded, the tax rates of 25% have been reduced, and the tax rates of 30%, 35% and 45% have not changed. The expansion of tax rate range of different grades below 20% of comprehensive income will further reduce the tax burden of low-income workers, maintain the highest tax rate of 30% - 45% of high income unchanged, and reflect the principle of vertical equity of personal income tax. According to data from the National Bureau of Statistics, the per capita disposable income of residents nationwide in 2018 was 28,228 yuan (2,235.33 yuan / month), of which the per capita disposable income of urban residents was 39,251 yuan (3,171 yuan / month). The exemption increased to 5,000 yuan, which is higher than the per capita disposable income of urban residents. Many low- and middle-income taxpayers do not need to pay taxes, which greatly reflects the determination of this tax reform to benefit the people.

Table 1 Comparison of Old and New Tax Rates

Series	Tax rate (%)	Old individual income tax (before October 1, 2018, exemption of 3500 yuan)		New personal tax (after October 1, 2018, the exemption is 5000 yuan)		Contrast result
		Taxable income (including tax)	Quick calculation deduction fee (yuan)	Taxable income (including tax)	Quick calculation deduction fee (yuan)	
1	3	No more than 1500 yuan	0	No more than 3000 yuan	0	Class distance expansion 1500 yuan
2	10	More than 1500 yuan to 4500 yuan	105	More than 3000 yuan to 12000 yuan	210	Class distance expansion 6000 yuan
3	20	More than 4500 yuan to 9000 yuan	555	More than 12000 yuan to 25000 yuan	1410	Class distance expansion 8500 yuan
4	25	More than 9000 yuan to 35000 yuan	1005	More than 25000 yuan to 35000 yuan	2660	Class distance expansion 16000 yuan
5	30	More than 35000 yuan to 55000 yuan	2755	More than 35000 yuan to 55000 yuan	4410	No change in step distance
6	35	More than 55000 yuan to 80000 yuan	5505	More than 55000 yuan to 80000 yuan	7160	No change in step distance
7	45	More than 80000 yuan	13505	More than 80000 yuan	15160	No change in step distance

(2) From January 1, 2019, four items of wages and salaries, remuneration for labor services, remuneration for contributions and royalties will be included in the comprehensive income scope. Other projects will continue to use the classified tax system, and a tax system framework combining the comprehensive and classification will be constructed. The withholding agent calculates the tax according to the cumulative withholding method, and reports on a monthly basis. The taxpayer settles the tax at the end of the year, refunds the tax in excess and makes up for the tax in shortage, which solves the problem that the previous annual income is the same. However, the tax differences caused by different income sources in different months are conducive to promoting the horizontal equity of personal income tax.

Under the original tax system, the three-level excess tax rates of 20%, 30% and 40% are applicable to the income from labor remuneration. The tax rates of royalties and remuneration are 20%. After tax reform, the income from wages and salaries are included in the annual income and charged at the tax rate of 3% - 45%. This means that for taxpayers with low incomes, the three income tax rates may be reduced from 20% to 3% or 10%, while for taxpayers with high overall incomes, it may increase from 20% to 45%. It can be seen that the comprehensive income tax rate and level have increased the adjustment of income, imposed heavy taxes on high-income earners, and less or no taxes on low-income earners, which is in line with the principle of vertical equity of personal income tax.

(3) The revised personal income tax law added “six special additional deductions”, including the most basic living costs of children's education, supporting the elderly, housing rent, housing loans, continuing education and serious illness medical treatment, as shown in Table 2: table of special additional deductions. This is the first time that personal income tax has considered the cost of living of taxpayers. After deducting additional costs, households with better economic affordability bear a higher proportion of tax burden, which is conducive to the vertical equity of personal income tax.

Table 2 Special Additional Deduction Items

Deduction items	Deduction range	Deduction	Deductions Technique
Children education	Preschool + academic education	12000 yuan / year / person (1000 yuan / month / person)	50% for parents or 100% for the intended party
Continuing Education	Diploma Education	4500 yuan / year (400 yuan / month)	Deduction period not more than 48 months
	Vocational qualification education	3600 yuan / year	In the year when the certificate is obtained, it shall be deducted according to the quota of 3600 yuan
Medical treatment for serious illness	Medical expenses for serious illness	After deducting the reimbursement of medical insurance, the part of personal burden accumulatively exceeding 15000 yuan	Deduct according to the facts within the limit of 80000 yuan
Loan interest	First housing loan interest expense	12000 yuan / year (1000 yuan / month)	The deduction period shall not exceed 240 months, which can be deducted by the husband and wife
Support for the elderly	Over 60 years old (included), not double deduction according to the number of old people	24000 yuan / year (2000 yuan / month)	Non only child can choose to apportion deduction, no more than 1000 yuan / month
Housing rent	Municipalities directly under the central government, provincial capitals and cities specifically designated in the state plan	18000 yuan / year (1500 yuan / month)	If the husband and wife are in the same city, the deduction shall be made by one party; if the husband and wife are in different cities, the deduction shall be made separately
	Cities with more than 1 million registered population	13200 yuan / year (1100 yuan / month)	
	Cities with registered population less than 1 million	9600 yuan / year (800 yuan / month)	

#### 4. The Part of Special Additional Deduction That Has Not Been Fully Deducted Cannot Be Carried Forward to the Next Year

Notice of the State Council on Printing and Distributing the Interim Measures for Special Additional Deductions for Personal Income Tax (Guo Fa [2018] No. 41): “Article 30 The special additional deductions for personal income tax cannot be deducted in a tax year and cannot be carried forward to subsequent years. For example, the medical insurance for serious illness can be deducted up to 80000 yuan. If the deductible amount can not be used up in the current year and can not be carried forward to the next year, the tax will be levied in the second year when the economic ability of the taxpayer's family is tested, which is extremely unreasonable.

#### 5. The Special Additional Deduction Amount Cannot Be Completely Transferred among Family Members

Among the six special additional deductions, only the interest deduction of children's education and housing loan is based on the family, which can be deducted on one side. The rest of the serious illness medical treatment, supporting the elderly, continuing education expenditure and housing rent expenditure are not optional. The special additional deduction amount can not be completely transferred among family members. Rugao pensions only include their own parents and do not include spousal parents. If only one spouse has a stable working income, it is actually the common pension for the parents of both spouses. However, the deducted expenses of the elderly caregiver only include the support of the parents, without considering the support of the in-laws or father-in-law. This is not only unreasonable, but also easily leads to family conflicts.

## **6. Special Additional Deductions Do Not Fully Consider Regional Differences**

Among the six types of special deductions, only the rent of housing is considered in three stages, and the other deductions do not take into account regional differences in living costs. For example, the limit of deduction of housing loan interest is 1000 yuan / month, which is relatively reasonable in the western inland cities, while the one size fits all 1000 yuan / month limit seems to be a drop in the bucket for tens of thousands of house prices in the first and second tier cities and coastal cities. For such deduction items with obvious regional differences, the deduction limit shall be determined with due consideration of the local price level and the specific situation of the cost of living, so as to adapt to local conditions.

### **6.1 Tax Rate Difference between Comprehensive Income and Classified Income**

The excess progressive tax rate of 3% - 45% is applicable to the four types of labor income: wages and salaries, labor remuneration, remuneration for contributions and royalties. The marginal tax rate is as high as 45%, and the proportional tax rate of 20% is still applicable to capital income such as dividends, property leasing, property transfer and contingent income. The marginal tax rate on labor income is higher than the capital income tax rate, which is inconsistent with the original intention of encouraging labor and hard work to become rich. And it may cause taxpayers to use this difference in tax rates to evade taxes. For example, entrepreneurs evade taxes by taking less wages, paying more dividends, or selling stocks to earn income. This is not in line with the principle of vertical equity of taxes.

### **6.2 The New Tax System Requires Taxpayers to Declare on Their Own, and Challenges Both Tax Authorities and Taxpayers**

Under the original tax classification system, each unit of income obtained was declared by the payment unit as a withholding agent and paid to the tax authority. Generally, the taxpayer will not be involved in tax reimbursement or refund. Individuals basically do not deal with tax authorities.

The new tax collection and management system has put the tax authorities to the test. From the original business withholding and payment to the direct connection with natural person taxpayers, the business volume may increase tens of thousands. Whether the tax department can use the big data platform to check the accuracy and authenticity of personal income and additional deduction information will determine the efficiency of individual tax collection and management. Under the new tax system, the application for additional deduction items, independent declaration and tax refund will be normal, requiring taxpayers to have higher tax consciousness and professional knowledge. Many taxpayers need the help of tax agents and accountants to complete the declaration work, and the tax payment cost will increase.

## **7. Measures to Solve the Existing Problems of Personal Income Tax**

### **7.1 Further Improve the Additional Deduction Policy, and Finally Realize the Expense Deduction Based on the Family**

The deduction amount of the parents' alimony expense and the interest of the house loan should be further optimized, and other deductions such as the child support cost and the parents' major medical expenses should be moderately increased. The cost deduction should be based on the family to solve the problem of the transfer of the deduction amount between family members, and the remaining part of the deduction amount can be improved by referring to the plan that the loss of enterprise income tax can be made up within five years. Establish a taxpayer identification number system to grasp information about taxpayer family members, income and expenditure, and family property. The total taxable income of the family's total income after deducting family expenses can best reflect "the actual affordability of the family" and can also reflect the principle of tax equity.

## **7.2 Continue to Promote the Comprehensive and Classified Taxation Model, and Finally Take the Comprehensive Tax System as the Goal of Reform**

For the construction of the personal income tax system, there are fair and efficient trade-offs. The comprehensive tax system calculates the taxable amount of various types of income of a taxpayer for a certain period of time, which can avoid the problem of manipulating income sources and reducing tax burden. The comprehensive income tax system is the most fair, but it has too high requirements for the taxpayer's tax awareness and the tax collection ability of the tax department. "The personal income tax system of combination of comprehensive and classification" is the best choice in the transition time, which combines the current collection and management ability and actual conditions of our country and takes into account the principle of efficiency and fairness. At present, we should constantly optimize the detailed rules of tax collection and management, and use the Internet and big data platform to improve the level of tax collection and management, so as to provide practical possibility for the realization of the comprehensive tax system.

## **7.3 The Tax Department Should Perfect the Personal Tax Collection and Management System in China from the Following Three Aspects**

First, the establishment of electronic tax service hall, the use of mobile terminal tax app to popularize online tax, and provide services such as automatic tax calculation, online consultation, policy interpretation and tax planning, to solve the worries of taxpayers without professional tax knowledge. Second, through the "Internet +" to achieve the taxation bureau, public security bureau, human resources and social security department, housing management bureau and other departments of information linkage and sharing mechanism, by industry, by income channel to monitor and manage tax sources. Third, strengthen the internal training of tax authorities, conduct tax training from various aspects such as taxation, accounting and computers, improve the professionalism and service awareness of tax personnel, and create a good tax environment.

## **7.4 Create a Good Tax Atmosphere and Increase Taxpayer Awareness**

The tax bureau can establish a taxpayer credit evaluation system through a tax collection and payment platform, publicize taxpayer rank lists, and link banks and other institutions to restrict bank loans to citizens with poor tax credit. Tax, tax evasion and illegal activities are tracked and reported through radio, television, and Internet platforms to create a good and orderly tax atmosphere. The tax department can conduct centralized training for the financial personnel of the withholding agent offline first to ensure that the withholding agent can understand the policy, operate and declare. At the same time, the tax policy compilation materials and video learning materials are released through the network platform, and the "Online + offline" publicity guidance is implemented. Let the taxpayers know the changes of tax policies in time, enjoy the reform dividend, enhance the tax identification of taxpayers, and promote the initiative and consciousness of citizens in tax payment.

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